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No. 83-832

In the Supreme Court of the United States

October Term, 1984

Harold T. Paulsen, et ux., petitioners

v.

Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether a taxpayer qualifies for nonrecognition of realized gain under Section 354(a)(1) of the Internal Revenue Code when, upon the merger of a stock savings and loan association into a mutual savings and loan association, he surrenders his stock in the former and receives a passbook savings account and short-term certificates of deposit in the latter.

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COMMISSIONER OF INTERNAL REVENUE

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 20-32) is reported at 716 F.2d 563. The opinion of the Tax Court (Pet. App. 1-18) is reported at 78 T.C. 291.

JURISDICTION

The judgment of the court of appeals (Pet. App. 33) was entered on August 16, 1983. The petition for a writ of certiorari was filed on November 14, 1983, and was granted on February 21, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of 12 U.S.C. 1464 and of Sections 116, 354, 356, 368, 581, 591, 593, 1002, and 7701(a)(19) of the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax year at issue, are set out in a statutory appendix (App., *infra*, 1a-11a).

STATEMENT

1. Petitioners were shareholders of Commerce Savings and Loan Association (Commerce), a state-chartered, stock institution that offered various classes of savings accounts to the public. On June 30, 1976, petitioners owned 17,459 shares of Commerce stock with a tax basis, or cost, of about $57,000. Petitioners' shares (called "guaranty stock") had all the features normally associated with common stock issued by a corporation. Pet. App. 2-3, 20-21; see J.A. 27-28.

Citizens Federal Savings and Loan Association (Citizens) is a federally-chartered, mutual institution that offers various classes of savings accounts to the public. As a mutual institution, Citizens has no capital stock. Each borrower is entitled to one vote, and each savings account holder is entitled to one vote for every $100 (or fraction thereof) on deposit (Pet. App. 3-4, 21). Regardless of the amount he has on deposit, no account holder is entitled to more than 400 votes (*id.* at 21). Citizens' articles and bylaws provide that its net earnings are to be distributed semi-annually to savings account holders on a pro rata basis (J.A. 43-44). In practice, however, it pays a fixed, preannounced rate on all accounts (Pet. App. 27). Citizens must honor requests for withdrawals from savings accounts within 30 days of the request (*id.* at 4). It may redeem all or any part of its accounts at a price equivalent to "the full value

thereof, as determined by the board of directors" (J.A. 42). In practice, however, the redemption price is the outstanding balance in the account (Pet. App. 21-22; J.A. 42). In the event of liquidation, dissolution, or winding up, all account holders are "entitled to equal distribution of assets pro rata to the value of their savings accounts" (Pet. App. 4-5, 21-22).

On July 1, 1976, Commerce was merged into Citizens. Under the merger plan, Commerce stockholders were to receive a $12 deposit in a Citizens passbook savings account for each share of Commerce stock they owned. Alternatively, they could surrender their stock for Citizens certificates of deposit (CDs) of various maturities.[1]

Pursuant to the merger, petitioners surrendered their 17,459 shares of Commerce stock for a Citizens passbook savings account and short-term CDs with an aggregate face amount and value of about $210,000.[2]

[1] The CDs had maturities ranging from one to ten years (J.A. 17). Deposits in passbook savings accounts issued in the merger could not be withdrawn for one year (*ibid.*), but each former Commerce stockholder was given preferential borrowing privileges against those deposits (Pet. App. 5, 22).

[2] The exact breakdown of the consideration petitioners received (Pet. App. 6) was as follows:

Number of Shares	Date of Acquisition	Cost Basis	Consideration Received Amount	Consideration Received Type	Gain Realized
3,356	3/8/63	$ 7,500	$ 40,272	Passbook	$ 32,772
3,359	6/26/70	7,500	40,308	2 yr. cert.	32,808
3,358	12/31/71	7,500	40,296	18 mos. cert.	32,796
3,358	10/24/72	7,500	40,296	18 mos. cert.	32,796
667	1/1/73	7,530	8,004	1 yr. cert.	474
1,971	2/19/74	6,000	23,652	3 yr. cert.	17,652
861	6/30/76	7,500	10,332	3 yr. cert.	2,832
529	6/30/76	5,772	6,348	4 yr. cert.	576
17,459		$56,802	$209,508		$152,706

They thus realized a gain of $153,000. Petitioners did not report this gain as income on their 1976 federal income tax return. Instead, they took the position that the transaction was a corporate "reorganization" and that the realized gain, accordingly, should not be currently recognized. Section 368(a)(1)(A) of the Code[3] defines "reorganization" to include "a statutory merger." Section 354(a)(1) generally provides that, in the case of two corporations participating in a reorganization, "[n]o gain or loss shall be recognized" to a shareholder whose stock in one is, pursuant to the plan of reorganization, exchanged solely for stock in the other. Petitioners contended that the Citizens savings accounts they received in the merger were "stock," since Citizens was a mutual institution, and since those accounts theoretically represented ownership interests in it.

2. On audit, the Commissioner determined that the merger was not a tax-free reorganization, and that petitioners were required to recognize their $153,000 gain immediately (Pet. App. 6; J.A. 8-13).[4] His determination was premised on the well-established principle that a transaction qualifies as an exchange pursuant to a "reorganization" only if it is not, in substance, a sale. In order to constitute a reorganization exchange rather than a sale, the transaction must evince a "continuity of proprietary interest." *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933); *LeTulle* v. *Scofield*, 308 U.S. 415 (1940). The ownership interest that the old corporation's shareholders acquire in the new corporation, moreover, must be "definite and material" and must "represent a substantial part of the value of the thing transferred." *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385 (1935).

The Commissioner determined that petitioners acquired no meaningful ownership interest in Citizens when they received the CDs and passbook savings account. He viewed those dollar obligations as constituting, not "stock," but a "hybrid interest, representing debt which is the equivalent of cash while, at the same time, having certain equity features" (Pet. App. 10). The Commissioner concluded that the accounts' equity features had minimal value, that their value did not "represent a substantial part of the value" (*Minnesota Tea*, 296 U.S. at 385) of the Commerce stock petitioners gave up, that petitioners in essence had become creditors of Citizens, and that the transaction was thus a sale. Alternatively, the Commissioner contended (J.A. 11-13) that, even if petitioners' ownership interest was sufficient to enable the transaction to qualify as a "reorganization," the dollar obligations they received in exchange for their stock represented, not "stock," but some combination of "securities," "money," and "other property," and that petitioners' gain had to be recognized up to the value of those non-equity interests. See I.R.C. §§ 354(a)(2), 356(a)(1) and (d).

3. Petitioners sought redetermiation of the resulting deficiency in the Tax Court. Following *Capital Savings & Loan Ass'n* v. *United States*, 607 F.2d 970

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax year at issue (the Code or I.R.C.).

[4] The Commissioner proposed to accord long-term capital gain treatment to $149,000 of petitioners' gain. He proposed to accord short-term treatment to the balance, on the ground that petitioners, in surrendering their stock, had engaged in an early disposition of 1,390 shares that they had acquired pursuant to stock options on the eve of the merger. See I.R.C. §§ 421, 422; J.A. 11-12, 15.

(Ct. Cl. 1979), *West Side Federal Savings & Loan Ass'n* v. *United States*, 494 F.2d 404 (6th Cir. 1974), and *Everett* v. *United States*, 448 F.2d 357 (10th Cir. 1971), the Tax Court held that the passbook savings account and CDs received by petitioners satisfied the "continuity of proprietary interest" test and that the transaction was, accordingly, a tax-free reorganization (Pet. App. 10-17). The Tax Court also rejected the Commissioner's alternative contention, concluding that "the cash deposit and proprietary rights represented by [the savings] accounts [were] not separable," that their proprietary rights rendered them "stock," and that the accounts thus necessarily could not be "securities," "money," or "other property" as the Commissioner urged (*id.* at 17-18 n.25). The court acknowledged that the Commissioner was "not without arguments" and that "treating savings accounts as 'stock' * * * raises a number of logical and practical administrative problems" (*id.* at 15-16 & n.22). But while the court suggested that it would have "give[n] greater weight to those problems in reaching [its] decision" if the question were one of first impression, it "fe[lt] constrained to follow the guidance" of the three appellate decisions cited above (*id.* at 16).

The court of appeals unanimously reversed (Pet. App. 20-32), following its earlier decision in *Home Savings & Loan Ass'n* v. *United States*, 514 F.2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975). The court acknowledged that the CDs and passbook savings accounts carried with them certain proprietary features, but concluded that their debt features "overwhelmingly predominate[d]" (Pet. App. 24), that they were "in reality indistinguishable from ordinary savings accounts" (*id.* at 30-31), and that they were "essentially the equivalent of cash" (*id.* at 31). Because the accounts, "though * * * ownership interests for some purposes, [did] not 'partake sufficiently of equity characteristics' to qualify [the] transaction as a tax free reorganization" (Pet. App. 32), the court held that petitioners in essence had sold their stock and were thus required to recognize their gain at once.

SUMMARY OF ARGUMENT

The Internal Revenue Code generally provides that "on the sale or exchange of property the entire amount of the gain or loss * * * shall be recognized" (26 U.S.C. (1970 ed.) 1002). Sections 354 to 368 set forth exceptions to this rule in the case of certain "exchanges" incident to a corporate "reorganization." These provisions allow parties exchanging property in a merger or similar transaction to avoid current recognition of gain or loss, *provided* that the transaction represents "only a readjustment of continuing interest[s] in property under modified corporate forms" (Treas. Reg. § 1.368-1(b)). The "reorganization" provisions presuppose that the investor's new property "is substantially a continuation of [his] old investment still unliquidated" (Treas. Reg. § 1.1002-1(c)). If the investor liquidates or "cashes out" his equity stake, the transaction is not a "reorganization exchange" but a "sale," and gain or loss must be recognized at once.

Once a "reorganization exchange," rather than a "sale," is found, the Code sets strict limits on the kinds of consideration that can be received tax-free. Section 354(a)(1), as relevant here, provides that a shareholder will recognize no gain or loss if he exchanges stock in one corporation which is a party to the reorganization solely for stock in another corpora-

tion which is a party to the reorganization. If, however, a shareholder surrenders only stock, and gets back, not just "stock," but also "securities" (generally, debt obligations), "money" or "other property," he must recognize his gain (if any) up to the value of those non-equity interests (I.R.C. §§ 354(a)(2), 356(a)(1), (d)(1) and (2)). These rules implement the basic principle of "reorganization" tax law, namely, that gain or loss must be recognized to the extent a taxpayer liquidates, rather than continues, his equity stake.

Here, petitioners surrendered their stock in Commerce for dollar obligations in Citizens. That transfer was not a tax-free "reorganization exchange," for two distinct reasons. First, while formally structured as a merger, the transaction was in reality a purchase of assets by Citizens and a sale of their Commerce stock by petitioners. Second, even if the transaction was a "reorganization," the consideration petitioners received was not "stock," but some combination of "securities," "money" and "other property," accompanied by a nominal equity participation. To the extent of the value of the non-equity interests petitioners received, therefore, they must recognize their gain in any event.

1. This Court has consistently held that a transfer of corporate assets for cash or dollar obligations is not a "reorganization exchange" but a sale. In order for a merger to qualify as a "reorganization," the transferor's shareholders must acquire in the transferee company an equity interest that is "definite and material" and that "represent[s] a substantial part of the value" of the total consideration they receive (*Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385 (1935)).

The equity stake petitioners acquired in Citizens did not "represent a substantial part of the value" of what they got in the merger. What they got, after all, were savings accounts in a federally-insured institution. Over a period of years since 1951, Congress has increasingly assimilated mutual S&Ls and their account holders to banks and their depositors. For federal tax purposes, those accounts since long before 1976 have been treated exactly like bank deposits, and the so-called "dividends" Citizens pays on those accounts have been treated exactly like interest paid by a bank.

It is true that petitioners' savings accounts were accompanied by certain proprietary features, viz., a limited right to vote and a contingent right to participate in the proceeds of a solvent liquidation. But those rights had no substantial value. In practice, depositors rarely exercise their voting rights and attach no importance to them. And this Court has noted that the solvent liquidation of a savings institution is "such a remote contingency" that any theoretical value of the right to participate in a liquidation "reduces almost to the vanishing point" (*Society for Savings* v. *Bowers*, 349 U.S. 143, 150 (1955)). Obviously, no one would pay anything, beyond the number of dollars on deposit, for the "equity features" accompanying petitioners' savings accounts, for one could acquire those equity features for free simply by using the same number of dollars to open an account in one's own name.

The value of the consideration petitioners received, in short, was almost wholly represented by the savings accounts' "debt features," viz., the right to withdraw $210,000 in cash on demand or at stated intervals. Since the accounts' equity features thus did

not "represent a substantial part of the value" (*Minnesota Tea*, 296 U.S. at 385) of the total consideration petitioners received, the court of appeals correctly held that the merger effected, not a "reorganization exchange," but a sale.

2. Even if petitioners' savings accounts were sufficiently imbued with equity characteristics to enable the overall transaction to qualify as a "reorganization," the effects of that reorganization *upon petitioners* would still have to be gauged by testing the consideration they received under Sections 354 and 356. Since petitioners surrendered only stock, they must recognize gain to the extent that they received, not just "stock," but "securities," "money" or "other property" (I.R.C. §§ 354(a)(2), 356(a)(1), (d)(1) and (2)).

Petitioners' savings accounts plainly do not constitute "stock" pure and simple. Rather, the accounts represent "hybrid interest[s]" (Pet. App. 10), short-term debt obligations accompanied by nominal equity features. There is no need in this case to decide whether the non-equity features of the savings accounts should be considered "securities," "money" or "other property." Since petitioners surrendered only "stock," they must recognize gain to the extent they got back anything but "stock," regardless of how those non-equity interests are denominated.

Here, as noted above, the nonstock rights that petitioners received consisted of the right to withdraw $210,000 in cash from Citizens. The fair market value of that right is stipulated to be $210,000. Since the value of the non-equity interests petitioners acquired thus exceeds the gain they realized ($153,000), they must recognize that gain in full. This result, of course, is the same as the result produced by our

primary submission—that the transaction was a sale and not a "reorganization exchange"—but that merely confirms that our primary submission is correct.

ARGUMENT

THE COURT OF APPEALS CORRECTLY HELD THAT THE GAIN PETITIONERS REALIZED WAS TO BE CURRENTLY RECOGNIZED IN THEIR 1976 TAXABLE YEAR

Section 1002 of the Code, effective during 1976,[5] stated that, "[e]xcept as otherwise provided in [subtitle A of the Code], on the sale or exchange of property the entire amount of the gain or loss * * * shall be recognized." Among the Code sections that "otherwise provide" are Sections 354 to 368, governing certain transactions in connection with "corporate reorganizations." Section 354(a)(1) says that "[n]o gain or loss shall be recognized" if stock or securities in a corporation which is a party to a reorganization are "exchanged solely for stock or securities * * * in another corporation [which is] a party to the reorganization." To qualify for nonrecognition of gain or loss, a transaction whereby a shareholder surrenders stock in one of the corporations must constitute, not a "sale," but an "exchange" that establishes a continuity of his proprietary interest in the other company. Treas. Reg. § 1.368-1(b).

Once a "reorganization exchange" is found, Sections 354(a)(2) and 356 limit the kinds of consid-

[5] Effective for taxable years beginning after December 31, 1976, Congress repealed Section 1002 and reenacted its provisions (with slight verbal changes) as Section 1001(c). Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(121) and (b)(28)(B)(i), 90 Stat. 1784, 1799.

eration that can be received tax-free. Section 356(a)(1) provides that, if a taxpayer receives, besides "stock or securities," "other property or money," he must recognize gain (if any) up to "the sum of such money and the fair market value of such other property." Section 354(a)(2)(B), moreover, imposes additional restrictions where securities (generally, debt obligations) are received "and no such securities are surrendered.". In such situations, the securities received constitute "other property" (I.R.C. § 356(d)(1) and (2)), and gain must be recognized up to the fair market value thereof (I.R.C. §§ 354(a)(2)(B), 356(d)(2)(B)). See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.31, at 14-97 (4th ed. 1979) (hereinafter cited as Bittker & Eustice) (citing cases). In short, if a shareholder participating in a "reorganization exchange" surrenders only stock, and gets back anything besides "stock," he must recognize gain (if any) up to the value of those non-equity interests.

The underlying assumption of the reorganization provisions, as of all the Code's tax-free exchange provisions, "is that the new property is substantially a continuation of the old investment still unliquidated." Treas. Reg. § 1.1002-1(c). The reorganization provisions were enacted "to free from the imposition of an income tax purely paper profits or losses wherein there is no realization of gain or loss in the business sense but merely recasting of the same interests in a different form." *Southwest Natural Gas Co.* v. *Commissioner*, 189 F.2d 332, 334 (5th Cir.), cert. denied, 342 U.S. 860 (1951) (quoting *Commissioner* v. *Gilmore's Estate*, 130 F.2d 791, 794 (3d Cir. 1942) (original quotation marks omitted)). The principle that a reorganization entails "only a readjustment of

continuing interest[s] in property under modified corporate forms" (Treas. Reg. § 1.368-1(b)) lies "at the heart of the nonrecognition provisions and is the reason why gain or loss, although realized, is not recognized at the time of the exchange." Bittker & Eustice ¶ 14.01, at 14-4. The converse of this principle, of course, is that a shareholder who liquidates or "cashes out" his equity investment, whether in whole or in part, must recognize gain at once.

Petitioners contend that their surrender of Commerce stock for Citizens' savings accounts was a tax-free reorganization exchange within the intendment of these provisions. It was not, for two distinct reasons. First, the transaction, while formally structured as a merger, was in reality a sale. Second, even if the merger was a "reorganization," the dollar obligations petitioners received were not "stock," and, since they surrendered only stock, those obligations could not be received tax-free.

A. The transaction in which petitioners surrendered stock in Commerce and received a passbook savings account and certificates of deposit in Citizens was not a reorganization, but a sale

This Court and others early found it necessary to differentiate between "sales" on the one hand and "reorganization exchanges" that will qualify to produce nonrecognition of gain on the other. The problem emerged in *Cortland Specialty Co.* v. *Commissioner*, 60 F.2d 937 (2d Cir. 1932), in which a corporation had transferred its assets to another corporation for cash and short-term promissory notes. The court, speaking through Judge Augustus Hand, held the transaction "a mere sale" (60 F.2d at 937, 940), notwithstanding its literal compliance with the

Code's then-existing definition of a reorganization.[6] A "reorganization," the court reasoned, "presuppose[s] a continuance of interest on the part of the transferor in the properties transferred" (*id.* at 940). The court accordingly held that "[a] sale of the assets of one corporation to another for cash * * * is quite outside the objects of merger and consolidation statutes" (*id.* at 939).

This Court soon faced the same problem in *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933). That case likewise involved an intercorporate transfer of assets for cash and short-term notes. Specifically approving Judge Hand's opinion in *Cortland Specialty*, this Court held that the facts "failed to show a 'reorganization' within the statutory definition" (287 U.S. at 469). "[T]he mere purchase for money of the assets of one Company by another," the Court reasoned, was "beyond the evident purpose of the [reorganization] provision, and ha[d] no real semblance to a merger" (287 U.S. at 469, 470). "[T]o be within the exemption," rather, "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes" (*id.* at 470).

In *LeTulle* v. *Scofield*, 308 U.S. 415 (1940), the consideration received by the transferor comprised

[6] A "reorganization" was then defined broadly to include "a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation)." Revenue Act of 1926, ch. 27, § 203(h)(1), 44 Stat. 14. Section 203(b)(3) of the 1926 Revenue Act, 44 Stat. 12, the predecessor of Section 361 of the 1954 Code, provided for nonrecognition of gain to a corporate party to a reorganization upon the exchange of property solely for stock or securities in another corporate party to the reorganization.

cash and long-term bonds. The Court recited its earlier holdings that, "where the consideration consists of cash and short term notes, the transfer * * * is a sale upon which gain or loss must be reckoned," and went on to hold that "the term of the obligations [was] not material" (308 U.S. at 420). "Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee" (*id.* at 420-421).[7]

These cases established that a transaction is a "sale" and not a "reorganization exchange" where the sole consideration received comprises debt obligations and cash. In *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378 (1935), this Court considered the proper outcome where the transferor receives some equity as well. The Court noted its holding in *Pinellas Ice* that

[7] The Treasury Regulations, drawing upon these cases, early formulated the difference between a sale and a reorganization in terms of the requirement of "continuity of proprietary interest." See Treas. Reg. 86, art. 112(g)(2) (1935) ("The term ['reorganization'] does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short term notes, the transaction is a sale and not an exchange."). This provision has been repeated, and expanded upon, in all succeeding regulations. *E.g.*, Treas. Reg. §§ 1.368-1(b), 1.368-2(a). The courts have uniformly held that these principles apply to intercorporate asset transfers, regardless of whether they are formally structured as a purchase of assets or (as here) as a statutory merger. See *Southwest Natural Gas Co.*, 189 F.2d at 334; *Roebling* v. *Commissioner*, 143 F.2d 810, 812 (3d Cir.), cert. denied, 323 U.S. 773 (1944).

a reorganization presupposes on the transferor's part a continuing " 'interest in the affairs of the purchasing company' " (296 U.S. at 385 (quoting 287 U.S. at 470)). "[W]e now add," the Court wrote, "that this interest must be definite and material" and "must represent a substantial part of the value of the thing transferred" (296 U.S. at 385). In the Court's view, it did not matter that "the relationship of the [transferor] to the assets conveyed was substantially changed," since this will invariably occur in a reorganization. The important point, rather, was to compare the value of the equity interest received to the value of the total consideration received, so as to determine whether the former "represent[ed] a substantial part of the value" of the latter (296 U.S. at 385, 386).[8]

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[8] The relative amounts of equity and non-equity consideration that can be received by the transferor consistently with the "continuity of proprietary interest" requirement have never been precisely defined. In *Minnesota Tea*, consideration comprising 56% common stock and 44% cash was held to suffice (296 U.S. at 381-382, 385). In *John A. Nelson Co.* v. *Helvering*, 296 U.S. 374 (1935), consideration comprising 38% equity (consisting of an entire issue of preferred stock) and 62% cash was likewise held satisfactory. See 296 U.S. at 376; Bittker & Eustice ¶ 14.11, at 14-19. Transactions in which equity represents less than 20% of the total consideration have almost invariably been considered sales. See, *e.g.*, *Southwest Natural Gas*, 189 F.2d at 334-335 (1% equity); *Yoc Heating Corp.* v. *Commissioner*, 61 T.C. 168, 177-178 (1973) (15% equity); *Kass* v. *Commissioner*, 60 T.C. 218, 227 (1973) (16% equity); Rev. Rul. 80-285, 1980-2 C.B. 119 (19% equity); Rev. Rul. 80-284, 1980-2 C.B. 117 (14% equity). For advance ruling purposes, the IRS regards 50% equity as sufficient for "continuity of interest" purposes. Rev. Proc. 77-37, 1977-2 C.B. 568, 569; Rev. Rul. 66-224, 1966-2 C.B. 114-115.

In the present case, petitioners surrendered their Commerce stock for Citizens dollar obligations—a passbook savings account and time certificates of deposit—that were functionally equivalent to short-term promissory notes. There can be no doubt under the cases discussed above that, if petitioners had transferred their a stock for identical consideration to an ordinary corporation, a commercial bank, or a stock savings and loan association, the transfer would be a sale and their gain would be immediately recognized. The only question is whether the result should be different here simply because the buyer was a mutual institution.

We submit that any such difference in result would be unjustifiable. Petitioners acknowledge that their savings accounts "in some ways resemble bank deposits" (Br. 6), yet assert that the resemblance is merely superficial and that, by becoming "members" in Citizens, they gained proprietary rights significantly different from the rights of a bank depositor. Their claim does not withstand analysis. The provisions of the Internal Revenue Code governing mutual savings and loan associations demonstrate that those institutions, for federal tax purposes, are substantially identical to banks, and that accounts maintained at those institutions, for federal tax purposes, are substantially identical to bank deposits. And when the merger is considered in pragmatic rather than in formal terms, it is clear that the equity features accompanying petitioners' accounts—which are the same equity features accompanying all of Citizens' savings accounts—did not "represent a substantial part of [their] value" (*Minnesota Tea*, 296 U.S. at 385), and that the merger, from both Citizens' and petitioners' points of view, was a sale.

1. In construing other statutes, this Court has held that withdrawable accounts in a savings and loan association, for purposes for the Securities Exchange Act of 1934, 15 U.S.C. 78a, constitute "securities" (*Tcherepnin* v. *Knight*, 389 U.S. 332 (1967)), and that such accounts, for purposes of 38 U.S.C. 3101(a) (relating to the exempt status of veterans benefits) "retain the qualities of moneys [which] have not been converted into permanent investments" (*Porter* v. *Aetna Casualty Co.*, 370 U.S. 159, 162 (1962)). Both decisions, of course, turned upon the language and purposes of the particular statutes under which the cases arose, and neither purported to establish a universal rule. But they do demonstrate that it is appropriate in this tax case to look first to the manner in which the Internal Revenue Code deals with savings and loan associations, particularly federally-chartered, mutual associations like Citizens. The evolution of the relevant Code provisions reveals a deliberate congressional intent increasingly to assimilate those institutions and their members to banks and their depositors.

Until 1951, most mutual savings banks, cooperative banks, domestic building and loan associations, and federal savings and loan associations were exempt from the federal income tax.[9] In 1951, however, Congress found that these institutions were in active

[9] The exemption for federal S&Ls was accomplished by the Home Owners Loan Act of 1933, ch. 64, § 5(h), 48 Stat. 133, 12 U.S.C. (1946 ed.) 1464(h). The exemption for the other three groups was accomplished by Section 101(2) and (4) of the Internal Revenue Code of 1939, ch. 2, 53 Stat. 33 (hereinafter 1939 Code).

competition with other financial institutions[10] and were no longer principally engaged in fulfilling the "mutual" functions for which they had been established.[11] The Senate Finance Committee noted that

[10] See, *e.g.*, S. Rep. 781 (Pt. 1), 82d Cong., 1st Sess. 25 (1951):

> At the present time, mutual savings banks are in active competition with commercial banks and life insurance companies for the public savings, and they compete with many types of taxable institutions in the security and real estate markets. As a result your committee believes that the continuance of the tax-free treatment now accorded mutual savings banks would be discriminatory. * * * The tax treatment provided by your committee would place mutual savings banks on a parity with their competitors.

[11] See, *e.g.*, S. Rep. 781, *supra*, at 27 (discussing state and federal S&Ls):

> In the early days of these institutions, the transactions of the associations were confined to members, and no one could participate in the benefits they afforded without becoming a shareholder. Individuals became investing members of these organizations in the expectation of ultimately becoming borrowing members as well. Membership implied not only regular payments to the association for a considerable period of time, but also risk of losses. Members could not cancel their memberships or withdraw their shares before maturity without incurring heavy penalties. The fact that the members were both the borrowers and the lenders was the essence of the "mutuality" of these organizations.
>
> Although many of the old forms have been preserved to the present day, few of the associations have retained the substance of their earlier mutuality. The steady decline in the proportion of share-accumulation loans is evidence that the character of these organizations has changed. More and more, investing members are becoming simply depositors, while borrowing members find dealing with a savings and loan association only tech-

"savings and loan associations are no longer self-contained cooperative institutions as they were when originally organized" and that "there is relatively little difference between their operations and those of other financial institutions which accept deposits and make real-estate loans." S. Rep. 781, 82d Cong., 1st Sess. 28 (1951). Accord, H.R. Conf. Rep. 1179, 82d Cong., 1st Sess. 71-73 (1951); H.R. Conf. Rep. 1213, 82d Cong., 1st Sess. 73-74 (1951).

Congress determined that maintenance of the existing tax exemption for mutual institutions under these circumstances would be "discriminatory" (S. Rep. 781, *supra*, at 25) and accordingly repealed it.[12] Consistently with that treatment, Congress amended the Code to allow mutual institutions a deduction for amounts placed in bad-debt reserves (similar to the deduction already granted banks), and to allow mutual institutions a deduction for amounts paid as "dividends" to their depositors (just as banks were permitted to deduct interest paid to theirs).[13] Congress likewise revised the definitional provisions of the 1939 Code to include most savings and loan associations, whether state- or federally-chartered, within the definition of "banks." [14]

Three years later, in the Internal Revenue Code of 1954, Congress for the first time provided an exclusion from gross income for up to $50 of "dividends from domestic corporations." Internal Revenue Code of 1954, ch. 736, § 116(a), 68A Stat. 37. Congress was careful to provide, however, that this exclusion was not available for "dividends" paid by S&Ls to their depositors and deducted by the former under Section 591. *Id.* § 116(c)(1). Congress provided, rather, that such dividends "shall not be treated as a dividend" for this purpose (*ibid.*).[15]

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nically different from dealing with other mortgage lending institutions in which the lending group is distinct from the borrowing group. In fact, borrowers ordinarily have very little voice in the affairs of most savings and loan associations.

One characteristic of the earlier mutuality which remains is the absence of capital stock. However, the character of the organization has been modified by the practice of paying more or less fixed rates of return on shares, and of building up substantial surplus accounts to protect shareholders against the risk of losses.

[12] Revenue Act of 1951, ch. 521, § 313(a), (b) and (c), 65 Stat. 490.

[13] Revenue Act of 1951, ch. 521, § 313(f), 65 Stat. 491, amending 1939 Code § 23(r), 53 Stat. 16. See S. Rep. 781, *supra*, at 28. The provision permitting mutual savings and loan associations to deduct "dividends" paid on deposits is now incorporated in I.R.C. § 591.

[14] Revenue Act of 1951, ch. 521, § 313(h), 65 Stat. 491, amending 1939 Code § 104(a), 53 Stat. 36 (revising definition of "bank" to include "a domestic building and loan association"); Revenue Act of 1951, ch. 521, § 313(i), 65 Stat. 491, adding 1939 Code § 3797(a)(19) (defining "domestic building and loan association" to include "a domestic savings and loan association" and "a Federal savings and loan association, substantially all the business of which is confined to making loans to members").

[15] In 1980, Congress temporarily amended Section 116 to provide an exclusion for up to $200 ($400 in the case of joint returns) of amounts received *either* as interest *or* as dividends from domestic corporations. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 404(a), 94 Stat. 305, amending I.R.C. § 116(a) and (b). "Interest" for that purpose was defined to include "interest on deposits with a bank" and "amounts (whether or not designated as interest) paid in respect of deposits * * * by a mutual savings bank, cooperative bank, [or] domestic building and loan association." *Id.* § 404(a), amending I.R.C. § 116(c)(1)(A) and (B).

In 1962, Congress expanded Section 591 to allow savings and loan associations to deduct, not only amounts paid "as dividends * * * on their deposits or withdrawable accounts," but also amounts paid "as dividends *or interest*" on those accounts.[16] Congress likewise drew a sharp line between "dividends" paid by S&Ls to their depositors (which were deductible under Section 591) and "distributions of property" paid by stock S&Ls to their shareholders (which were not to be deductible under Section 591).[17] Such "distributions of property," rather, were made subject to the provisions of the Code dealing with ordinary corporate dividends (I.R.C. §§ 301, 312, 317(a)), redemptions (I.R.C. § 302), and liquidations (I.R.C.

[16] Revenue Act of 1962, Pub. L. No. 87-834, § 6(f), 76 Stat. 984 (emphasis added), amending I.R.C. § 591. Congress in the same provision made the Section 591 deduction available to "other savings institutions chartered and supervised as savings and loan or similar associaitons under Federal or State law," even if they did not come within the definition of "domestic building and loan associations" set forth in Section 7701(a)(19). See S. Rep. 1881, 87th Cong., 2d Sess. 191 (1962); H.R. Conf. Rep. 2508, 87th Cong., 2d Sess. 24 (1962). At the same time, Congress amended and expanded the Section 7701(a)(19) definition to include almost all federal S&Ls, regardless of whether "substantially all [their] business * * * [was] confined to making loans to members." Compare Revenue Act of 1962, § 6(c), 76 Stat. 982-983, with 26 U.S.C. (1958 ed.) 7701(a)(19). This expansion reflected Congress's belief that S&Ls, in practice, were operating in the same fashion as other lending and financial institutions, *e.g.*, by making loans that were not in substance loans to members, but which were brought into conformance by making instantaneous "members" of borrowers. See H.R. Rep. 1447, 87th Cong., 2d Sess. 37, A49-A50 (1962); H.R. Conf. Rep. 2508, *supra*, at 21-23.

[17] Revenue Act of 1962, § 6(a), 76 Stat. 977-982, adding 26 U.S.C. (1964 ed.) 593(f) (currently codified as I.R.C. § 593(e)).

§§ 331, 346), provisions that, despite petitioners' suggestion to the contrary (Br. 41), are clearly inapplicable to withdrawals from savings accounts. See H.R. Rep. 1447, 87th Cong., 2d Sess. 36, A48 (1962); S. Rep. 1881, 87th Cong., 2d Sess. 47, 187-188 (1962). These amendments demonstrate a clear congressional intent that mutual savings accounts should not be treated as "stock" for federal tax purposes, since the "dividends" paid on those accounts are not subject to any of the rules applicable to dividends paid on stock generally.

Throughout this period, the capital structure of federal savings and loan associations was governed by Section 5(b) of the Home Owners' Loan Act of 1933, ch. 64, 48 Stat. 132, which provided that "[s]uch associations shall raise their capital only in the form of payments on * * * shares" and that "[n]o deposits shall be accepted" by them. In 1958, a group of commercial banks challenged the validity of Bank Board regulations issued under Section 5(b), contending that the regulations improperly authorized S&Ls to raise capital by accepting deposits and thus illegally to compete with banks. *Wisconsin Bankers Ass'n* v. *Robertson*, 294 F.2d 714 (D.C. Cir.), cert. denied, 368 U.S. 938 (1961). The court of appeals upheld the regulations, even though they defined S&L capital to include "payments on savings accounts" rather than "payments on shares" (294 F.2d at 716), and even though savings and loan associations were "coming to be regarded by the public much as the equivalent of a bank" (*id.* at 717 (Burger, J., concurring)).[18]

[18] Petitioners err (Br. 26-27) in relying on the concurring opinion of Judge (now Chief Justice) Burger in *Wisconsin Bankers* to support their position here. Judge Burger noted

In 1968, however, Congress decided that the formal capital structure of federal S&Ls should be brought more nearly into conformity with the public view of those institutions. It accordingly amended Section 5(b) to permit them to raise capital, not only in the form of "payments on shares," but in the form of "savings deposits, shares, or other accounts, for fixed, minimum, or indefinite periods of time * * * [or by issuing] such passbooks, time certificates of deposit, or other evidence of savings accounts as are * * * authorized." [19] The following year, Congress amended

(294 F.2d at 717) that, even though "[t]he superficial similarities of [S&L] associations to banks [are] admittedly very great," the validity of the Board's regulations turned not on "appearances but [on] legal realities." Under the version of Section 5(b) then in effect, he observed, a savings and loan association was required to raise capital "by payments on shares" (294 F.2d at 717), and he found no reason to conclude that the Board's regulations, in speaking of "payment on savings accounts," intended improperly to expand their statutory powers. As noted in the text (pages 24-25), however, Congress has since amended Section 5(b) to permit S&Ls to raise capital by issuing all manner of depositary instruments, so that the "legal realities" as well as the economic appearances now confirm their bank-like nature. In any event, Judge Burger carefully tied his analysis to Section 5(b) of the Home Owners Loan Act. The question here concerns the proper construction of the Internal Revenue Code, and it is well established that the "substance" rather than the "form" of transactions governs for federal tax purposes. *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[19] Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 1716(a), 82 Stat. 608, amending 12 U.S.C. 1464(b). See H.R. Rep. 1585, 90th Cong., 2d Sess. 152 (1968); H.R. Conf. Rep. 1785, 90th Cong., 2d Sess. 164 (1968). In Section 1716(b) of the same law (82 Stat. 608) Congress amended Section 5(c) of the 1933 Act, 12 U.S.C. 1464(c), to provide that S&Ls should make loans "on the security of [their] savings accounts" rather than "on the security of their shares." More recently, Congress has authorized federal S&Ls to accept demand deposits which have the same priority on liquidation as savings accounts, and to issue accounts that are subject to check or negotiable order of withdrawal. Thrift Institutions Restructuring Act of 1982, Pub. L. No. 97-320, § 301, 96 Stat. 1469, amending 12 U.S.C. 1464(b)(1)(A), (B) and (E).

the definition of "domestic building and loan association" in Section 7701(a)(19) of the Internal Revenue Code to conform it to the broadened provisions of Section 5(b) of the 1933 Act.[20] As amended, Section 7701(a)(19)(B) defined such associations to include those whose business "consists principally of acquiring the savings of the public and investing in loans"—a definition that aptly describes banks as well.

Petitioners lay great emphasis on the notion that their savings accounts are technically called "share accounts" (Br. 2, 3, 5) and that Citizens' charter permits it to raise capital only by accepting payments on accounts which "represent share interests in the association" (Br. 2, 18). The statutory developments outlined above, however, demonstrate that this terminology, for federal tax purposes at least, is a formalistic anachronism. Mutual savings and loan associations perform an economic function substantially similar to that performed by banks, and they are governed by a federal tax regime substantially similar to that governing banks. Their savings accounts, while retaining a name that sounds like equity, are for all practical purposes equivalent to debt, and are treated by the Internal Revenue Code

[20] Tax Reform Act of 1969, Pub. L. No. 91-172, § 432(c), 83 Stat. 622.

as bank deposits and not as stock. The court of appeals thus correctly concluded (Pet. App. 30-31) that petitioners' savings accounts, "despite certain formal equity characteristics, are in reality indistinguishable from ordinary savings accounts and are essentially the equivalent of cash." [21]

2. The conclusion that petitioners' accounts were essentially bank deposits, dictated by the statutory developments outlined above, is confirmed when one considers the economic realities of the merger involved here. That transaction was plainly regarded by Citizens as a "purchase" and by petitioners as a "sale." For tax purposes it should be treated the same way.

a. By virtue of the merger, Citizens acquired another savings and loan association—its bricks and

[21] As petitioners note with some frequency (Br. 5, 11, 28, 29, 35), the definitional provisions of the Code generally provide that "[t]he term 'stock' includes shares in an association" and that "[t]he term 'shareholder' includes a member in an association." I.R.C. § 7701(a)(7) and (8). Those general definitions, however, apply only where not "manifestly incompatible with the intent" of other, more particular, Code provisions. I.R.C. § 7701(a) (first sentence). To treat S&L share accounts as "stock" would be "manifestly incompatible" with Section 593(e), which draws a sharp line between the "dividends" paid on such accounts and true corporate dividends. See pages 22-23, *supra*. And to treat S&L share accounts as "stock" would be "manifestly incompatible with the intent" of the Code's reorganization provisions, which presuppose a continuity of proprietary interest. Far more relevant to decision here is the definition of "domestic building and loan association" contained in Section 7701(a)(19), which, as noted above (pages 21 & note 14, 22 & note 16, 24-25, *supra*), represents the culmination of a process by which savings and loan associations for tax purposes were gradually assimilated to banks.

mortar, its typewriters and automatic tellers, and, most importantly perhaps, its customer base. Citizens paid for its acquisition with various types of short-term debt. Those instruments, because subject to withdrawal on demand or at stated maturities, are obviously "liabilities" in an economic and balance-sheet sense. It is true that Citizens, like many buyers, elected to finance its purchase by making its dollar obligations due serially over time. But a purchase thus financed is a purchase just the same.

For analytical purposes, it is revealing to note the tax consequences of "reorganization" treatment for an *acquiring* corporation like Citizens. The decisions differentiating between "sales" and "reorganizations" have generally arisen in litigation by the transferor corporation or its shareholders claiming nonrecognition of gain. But the reasons for differentiating sales from reorganizations are equally weighty when the effects upon the acquiring corporation are considered.

Section 362(b) of the Code generally provides a "carryover basis" for assets received by a corporation in a corporate reorganization. It says that "[i]f property [is] acquired by a corporation in connection with a reorganization * * *, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." Suppose, for example, that Corporation A transfers assets with a fair market value of $40,000, but with a tax basis of $100,000, to Corporation B, which issues its notes in the amount of $40,000 to Corporation A or its shareholders.[22]

[22] The fair market value of Corporation A's assets might be lower than their tax basis, *e.g.*, because Corporation A's business was poor or because it was in failing circumstances. These conditions, of course, have not been uncharacteristic of the savings and loan industry in recent years.

Corporation B will take the assets with a basis of \$100,000 if the transaction is held to be a reorganization, but with a basis of \$40,000 if the transaction is held to be a sale. Thus, in the case of a reorganization, a transferee corporation receiving high-basis property will receive a *permanent* tax benefit, to be realized via higher depreciation deductions or in the computation of a loss upon disposition of the property acquired.[23] The result is that, when a corporation uses dollar obligations to acquire property, it is vital for proper administration of the tax laws to recognize that the transaction is a purchase for the amount of the dollar obligations issued. Otherwise, to use the figures of our example, the acquiring corporation will receive property with a basis of \$100,000 by paying only \$40,000. Cf. *Civic Center Finance Co.* v. *Kuhl*, 83 F. Supp. 251 (E.D. Wis. 1948), aff'd, 177 F.2d 706 (7th Cir. 1949).

In this case, Citizens acquired the assets of Commerce by issuing its dollar obligations to the former shareholders of Commerce, and by assuming dollar for dollar the savings accounts and other liabilities of Commerce. There is no reason why the assets Citizens has purchased should not take a basis in its hands measured by the dollar obligations it has undertaken, *i.e.*, their cost, and every reason why they should.

b. From petitioners' viewpoint, conversely, the merger plainly had all the earmarks of a "sale." Petitioners traded their Commerce stock for dollar

[23] This permanent tax benefit accruing to the transferee corporation is to be contrasted with the deferral benefit realized by the transferor's shareholders, for whom recognition of gain is simply postponed until the stock or securities received in the reorganization are sold.

obligations resembling bank deposits. Although those obligations in a technical sense carried with them certain proprietary features, it can scarcely be imagined that those features loomed large at the bargaining table, or that petitioners attached any real importance to them. The merger agreement (J.A. 54-71) evidently reflects a determination (presumably based on appraisals) that petitioners' stock was worth \$12 a share, and the consideration petitioners received for each share was a \$12 deposit in a savings account. If petitioners really thought that the accounts' "equity characteristics" had any material worth, Citizens presumably could have persuaded them to surrender each share of stock for a savings account deposit materially smaller than that sum. At all events, it is plain that the proprietary features accompanying the accounts did not "represent a substantial part of the value" (*Minnesota Tea*, 296 U.S. at 385) of the total consideration petitioners received.

Petitioners emphasize (Br. 16, 19) that they gained the right to vote as "members" of Citizens. They dismiss the voting rights of Citizens' borrowers, who clearly enjoy no proprietary interest, as "nominal" (Br. 18). But petitioners' own right to vote—one vote per \$100 in their accounts—was limited to 400 votes (Pet. App. 27), so that they could not cast the 2,096 votes to which, had there been no arbitrary limit, their alleged "equity interest" should have entitled them. Their limited right to vote, moreover, was "infinitely dilutable" (Pet. App. 27) upon the addition of new borrowers, enrollment of new depositors, and any increase in existing depositors' amounts on deposit.[24] The right to vote in most savings and

[24] While acknowledging that Citizens' charter permits it to raise an unlimited amount of capital (Br. 20-21), petitioners

loan associations, as in mutual insurance companies, is usually more formal than substantial; the governing boards in fact tend to be self-perpetuating. See *York* v. *Federal Home Loan Bank Board*, 624 F.2d 495, 497 n.1 (4th Cir.), cert. denied, 449 U.S. 1043 (1980) ("[i]n practice, a depositor [in a mutual S&L] signs a proxy form when first opening an account which allows the officers of the association to cast [his] votes as they see fit."). The right to vote, in any event, is not in itself a proprietary interest. The graduates of many educational institutions, as well as the members of countless nonprofit organizations, vote to elect some or all of the members of the governing boards, but they can hardly be said to have a proprietary interest.

Petitioners stress that their savings accounts give them the opportunity to receive payments that Citizens styles "dividends." They make much of the fact that they are not "legally entitled" to these payments (Br. 22); that the payments are theoretically made "out of [the] profits of the enterprise" (*ibid.*); and that, according to Citizens' charter, "[t]he amount of the distribution on accounts, if any, is determined and declared periodically by the Board of Directors" (*id.* at 23). But petitioners see the form and miss the substance. They acknowledge that Citizens in fact "pays a fixed, preannounced rate on all accounts" (Pet. App. 27). They cite no instance where

note that the charter grants the board of directors the power, inter alia, "[t]o reject any application for savings accounts or memberships" (J.A. 50). This provision has the ring of boilerplate, and petitioners do not suggest that the power is ever exercised in practice. In practice it seems most unlikely that it ever would be, for to do so would be to turn away business.

the Board of Directors has "determined and declared" any other rate. The "dividends" Citizens pays on its savings accounts are treated for federal tax purposes exactly like the interest paid by stock S&Ls and banks.[28] And common sense shows that this tax treatment accurately reflects the economic reality, for "[i]t is fanciful to suggest that depositors deciding where to put their money attach any weight to whether an institution is a mutual or a stock association" (Pet. App. 27-28). The market-

[28] As noted above (see pages 20-21, *supra*), Citizens' dividends (unlike normal corporate dividends) are deductible by it (I.R.C. § 591) and do not qualify for the "dividend exclusion" in its depositors' hands (I.R.C. § 116(c)(1)). Petitioners note (Br. 23-24) that the Commissioner, in a pair of rulings issued thirty years ago and in a different context, once took the view that S&L account holders should treat their dividends as "dividends" rather than as "interest." Rev. Rul. 54-624, 1954-2 C.B. 16, 18; I.T. 4045, 1951-1 C.B. 34. Those rulings, however, were declared obsolete in 1972 and 1968 respectively. Rev. Rul. 72-621, 1972-2 C.B. 651; Rev. Rul. 68-100, 1968-1 C.B. 572. As we have observed (pages 18-25, *supra*), much has changed in the world of S&Ls (including significant changes in their treatment by Congress) since 1954, and the IRS has long since instructed taxpayers to report S&L "dividends" as interest, and not as dividends, on their personal tax returns. See IRS, *Instructions for Preparing Form 1040*, at 9 (1984); IRS, *Publication No. 17, Your Federal Income Tax* 35-36, 38 (1977) (for use in preparing 1976 tax returns). Instructions for preparation of information returns by payors likewise state that so-called "dividends" on "share accounts" in federal S&Ls should be reported on Form 1099-INT, and not on Form 1099-DIV. See IRS, *Instructions for Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) and Forms 1099-ASC, 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, and 5498*, at 5 (1984).

place ensures that "interest paid by mutual associations is competitive with interest paid by stock associations and commercial banks" (*id.* at 28), and the name attached to the payment is not likely to make any difference to the depositor.

Petitioners also stress (Br. 20) the fact that, if Citizens should ever be dissolved or wound up, all its savings account holders would share pro rata in the distribution of its assets. But that problematic interest, subject in any event to Citizens' power to redeem all or any part of its accounts, has been described by this Court (*Society for Savings* v. *Bowers*, 349 U.S. 143, 150 (1955)) in terms that demonstrate its insubstantiality:

> If a depositor withdraws from the bank, he receives only his deposits and interest. If he continues, his only chance of getting anything more would be in the unlikely event of a solvent liquidation, a possibility that hardly rises to the level of an expectancy. It stretches the imagination very far to attribute any real value to such a remote contingency, and when coupled with the fact that it represents nothing which the depositor can readily transfer, any theoretical value reduces almost to the vanishing point.

Indeed, it was on this basis that the Fourth Circuit recently ruled that a "member" (*i.e.*, depositor) of a federal mutual S&L could not block conversion into a stock form of organization, holding that depositors would not thereby be deprived of property rights since their "only actual rights, their rights as creditors of the association, will remain unchanged." *York* v. *Federal Home Loan Bank Board*, 624 F.2d at 500.

Ultimately, petitioners' claim to reorganization treatment seems to rest on the observation (Br. 6)

that Citizens' savings account holders own all the "equity" there is in the association. Under these circumstances, petitioners contend, failure to acknowledge the substantiality of their proprietary interest would be tantamount to holding that mutual institutions have no owners. It is this argument that seems to have persuaded other courts of appeals to reject the Commissioner's view of the transaction involved here. See *Capital Savings & Loan*, 607 F.2d at 976; *West Side Federal Savings & Loan*, 494 F.2d at 411.

The argument, however, misconceives the Commissioner's position. The Commissioner has never contended, either in this case (see page 5, *supra*) or in earlier cases (*e.g.*, *Capital Savings & Loan*, 607 F.2d at 972), that account holders in a mutual institution have *no* proprietary rights. See Rev. Rul. 69-6, 1969-1 C.B. 104. The government's position, rather, is that the proprietary rights acquired by the transferor corporation's stockholders in a transaction of this sort are too insubstantial to convert into a "reorganization" what bears all the earmarks of a "sale."

As the court of appeals aptly noted (Pet. App. 30), petitioners' argument fails to distinguish between the relevance of the savings accounts' proprietary features to Citizens' balance sheet on the one hand, and to the former Commerce stockholders on the other. There can of course be "little doubt that the passbook accounts are equity in the sense that they represent [Citizens'] entire capital structure" (Pet. App. 30). Business organizations like Citizens, whether or not they have stock outstanding, are presumptively owned by someone. The fact that an "equity component" to the savings accounts is a logical necessity from Citizens' point of view, however, does not mean that those equity features, from petitioners' point of

view, "represent[ed] a substantial part of the value" (*Minnesota Tea*, 296 U.S. at 385) of what they got. Under this Court's cases, it is not merely the *existence* of equity features, but their *materiality* and *substantiality*, that determine whether a merger is a "reorganization" or a "sale." See *id.* at 385-386; *John A. Nelson Co.* v. *Helvering*, 296 U.S. 374, 377 (1935).

The court of appeals correctly held that the equity features incorporated in petitioners' savings accounts had insubstantial value and that the accounts' "debt characteristics overwhelmingly predominate[d]" (Pet. App. 24). Indeed it is obvious, as a matter of common sense, that no one would pay anything extra, beyond the number of dollars on deposit, for the "equity features" accompanying petitioners' accounts, for one could acquire those equity features for free simply by using the same number of dollars to open an account in one's own name. Petitioners plainly regarded the accounts—as one would regard any checking or savings account—as the equivalent of cash. Petitioners' investment was virtually risk-free, being represented by short-term accounts that were federally insured.[26] The accounts were subject to withdrawal by petitioners and to retirement at the

[26] Petitioners note (Br. 22) that federal insurance for savings accounts in mutual institutions is generally limited to $100,000 per depositor. 12 U.S.C. 1728(a). This limitation, however, does not substantially diminish the relatively risk-free, and therefore non-equity, nature of such obligations. As noted above (see page 29, *supra*), moreover, Citizens' account holders are entitled to no voting rights with respect to deposits in excess of $40,000. To the extent that deposits over $100,000 are subject to some theoretical risk, therefore, they also lack the voting rights that petitioners elsewhere regard (Br. 19) as crucial to a true "equity" stake.

will of Citizens, and thus in no sense represented a permanent contribution to the association's capital. And the accounts' "market value" was clearly equal to the sum of their "debt characteristics," *i.e.*, the principal balance outstanding plus any interest accrued thereon.

In short, while petitioners clearly had an equity interest in Commerce, they just as clearly received what was in substance a creditor's interest in Citizens. Far from continuing the proprietary stake they previously held, they essentially cashed their investment out. Because the merger thus failed to evince the "continuity of proprietary interest" requisite to a "reorganization" under the Internal Revenue Code, the transaction was properly treated as a sale of petitioners' stock producing currently taxable gain.[27]

[27] Petitioners seek to characterize both the decision below (Br. 5-6, 14-15) and the Commissioner's position (Br. 5-6, 16) as making satisfaction of the "continuity of interest" requirement turn, erroneously, on "the perceived degree of change in the proprietary interest received," rather than on "the nature of the interest received" (Br. 16). This is a mischaracterization in both respects. As petitioners (Br. 15) correctly observe, this Court in *Minnesota Tea* held that "continuity of interest" does not depend on whether "the relationship of the [transferor] to the assets conveyed [has] substantially changed," but on whether the value of the equity interest received "represent[s] a substantial part of the value of the thing transferred.'" See 296 U.S. at 385-386 and page 16, *supra*. Consistently with *Minnesota Tea*, however, the Commissioner here does not seek to deny "reorganization" treatment because the proprietary interest petitioners acquired—relatively speaking—was a somewhat different form of proprietary interest than the one they gave up. The Commissioner seeks to deny "reorganization" treatment, rather, because the value of the proprietary interest petitioners acquired—viewed in absolute terms—was an insubstantial part of the

B. Even if the merger of Commerce into Citizens was a "reorganization," petitioners must recognize gain up to the fair market value of the non-equity interests that they received

1. A finding that an intercorporate exchange is a "reorganization" does not necessarily mean that no gain will be recognized to the transferors. Sections 354 and 356 of the Code impose strict limitations on the types of consideration that can be received tax-free. Section 354(a)(1), as noted above, affords non-recognition treatment only when "stock or securities in [one] corporation a party to [the] reorganization are * * * exchanged solely for stock or securities * * * in another corporation a party to the reorganization." Section 356(a)(1) provides that, if a taxpayer receives, besides "stock or securities," "other property or money," he must recognize his gain (if any) up to "the sum of such money and the fair market value of such other property." Section 354(a)(2)(B), moreover, imposes additional restrictions where "securities are received and no such securities are surrendered." In such situations, the securities received constitute "other property" (I.R.C. § 356(d)(1) and (2)), and gain must be recognized up to the fair market value thereof (I.R.C. §§ 354(a)(2), 356(d)(2)(B)).

In this case, petitioners traded their Commerce stock for Citizens savings accounts. Even if those

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total consideration they received, *i.e.*, did not "represent a substantial part of the value of the thing transferred" (*Minnesota Tea*, 296 U.S. at 385). The court of appeals based its decision on the same ground, concluding that the savings accounts' equity features had minuscule value (Pet. App. 25-32) and that their debt features "overwhelmingly predominate[d]" (*id.* at 24). This analysis is not inconsistent with, but is mandated by, this Court's decisions.

accounts are imbued with sufficient equity characteristics to satisfy the "continuity of proprietary interest" test, and thus to enable the overall transaction to qualify as a "reorganization," the effects of the reorganization exchange *on petitioners* must still be gauged by testing the consideration they received under Sections 354 and 356. Since petitioners surrendered only stock, they must recognize gain under those Sections to the extent that they acquired, not just "stock," but "securities," "money" or "other property."

The savings accounts petitioners received plainly do not constitute "stock" pure and simple. Rather, as the Commissioner pointed out below, they constitute "a hybrid interest, representing debt which is the equivalent of cash while, at the same time, having certain equity features" (Pet. App. 10). The "hybrid" nature of mutual savings accounts has been recognized, not only by the court of appeals below (Pet. App. 30, 32), but also by the Tax Court (*id.* at 14) and the other courts that have sustained "reorganization" treatment for mergers of this sort (*Capital Savings & Loan*, 607 F.2d at 974; *West Side Federal Savings & Loan*, 494 F.2d at 411). And leading commentators have recognized that, in the case of such "hybrid" interests, where "a single instrument * * * constitute[s] 'stock' but also embod[ies] rights of a 'nonstock' character," the transaction, "[t]o the extent of the value of the latter rights, * * * may be outside the reorganization provisions." Bittker & Eustice ¶¶ 14.11, 14.31, at 14-21, 14-95 n.242.

Here, petitioners clearly acquired "rights of a nonstock character" in addition to whatever proprietary interests they obtained in Citizens. What they ac-

quired, after all, were federally-insured savings accounts withdrawable more or less at will. Although petitioners' "rights of a nonstock character" have a strong flavor of cash equivalency, there is no need in this case to decide whether those rights should be considered "securities," "money," or "other property" (see page 12, *supra*). Since petitioners surrendered only stock, they must recognize gain to the extent they received anything but stock, regardless of how those non-equity interests are denominated (I.R.C. §§ 354, 356).

2. The Tax Court rejected this reasoning because it thought the equity and non-equity features of petitioners' savings accounts were inseparable. In the Tax Court's view, Sections 354 and 356 are meant to apply "where property qualifying for 'tax-free' exchange [is received] and, *in addition*, some other property or money is received" (Pet. App. 17 n.25 (emphasis original)). "Here," the Tax Court noted, "petitioners received only one type of property, [namely,] savings accounts * * * in the form of passbooks and time certificates" (*ibid.*). The court then cited *Capital Savings & Loan*, *supra*, for the proposition that "the cash deposit and proprietary rights represented by [mutual savings] accounts are not separable" (Pet. App. 17 n.25, citing 607 F.2d at 977), and concluded that petitioners' accounts, if they embodied any equity features at all, must necessarily be "stock," without more.

The Tax Court's reasoning betrays a curious formalism. It is of course true that a savings account is physically represented by a single piece of paper, and that one cannot detach and sell the account's equity component as one could detach and sell (say) a stock warrant that accompanies certain types of bonds.

But that does not mean that it is impossible to separate out the stock and nonstock *rights* that a savings account incorporates. Obviously, if petitioners had transferred their Commerce stock to a *stock* savings and loan association, and had received a package comprising stock and savings accounts, they would have to recognize gain up to the value of the latter. Similarly, if petitioners had transferred their Commerce stock to a *mutual* savings and loan association, and had received a package comprising cash and "membership rights," they would have to recognize gain in the amount of the former. It cannot seriously be contended that the result should be different here simply because petitioners got cash equivalents instead of cash, or because their creditor and membership rights were bound up in one piece of paper rather than in two.[28]

Differentiating "equity-flavored" instruments into their stock and nonstock components is not uncommon in the tax law, either in the reorganization area [29] or

[28] Even if the Tax Court were correct in thinking that the physical inseparability of the accounts' "stock" and "nonstock" features should make a conceptual difference, it is hard to see why that court chose to characterize them the way it did. As the Tax Court recognized (Pet. App. 14), the accounts are a "hybrid" of debt and equity combined. If it were necessary to categorize the accounts as being exclusively one or the other, the logical approach seemingly would be to ascertain which features are dominant, and classify the whole accordingly. Here, it seems obvious that the accounts' debt features are predominant, so that they would not be "stock" even on the Tax Court's "inseparability" theory.

[29] See, *e.g.*, Rev. Rul. 69-265, 1969-1 C.B. 109, 109-110 (analyzing value of conversion rights incorporated in convertible preferred stock, and concluding that conversion rights represented "property other than voting stock" for purposes

in other areas,[30] and such a differentiation is clearly called for here. There is no reason why petitioners should qualify for *complete* nonrecognition of gain upon receipt of instruments that, if issued by any other entity, would produce recognition of gain in full, merely because the instruments they received happen to have *some* equity features. Rather, petitioners should be required, as taxpayers in all other kinds of reorganizations are required, to recognize gain up to the value of the non-equity interests received in the exchange. I.R.C. §§ 354(a)(2), 356 (a)(1) and (d)(2)(B).[31]

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of Section 368(a)(1)(C)); Rev. Rul. 70-108, 1970-1 C.B. 78, 79 (analyzing value of additional stock-purchase rights incorporated in convertible preferred stock, and concluding that such rights "constitute[] property other than solely voting stock" for purposes of Section 368(a)(1)(B)). See generally Bittker & Eustice ¶ 14.31, at 14-94 to 14-101.

[30] See, *e.g.*, Rev. Rul. 61-18, 1961-1 C.B. 5, 7 (analyzing stock into true equity and "associated rights" for purposes of determining the character of gain realized upon sale).

[31] In taking the position that the stock and nonstock components of petitioners' savings accounts were not "separable," the Tax Court (Pet. App. 17-18 n.25) seemed to think that the Commissioner himself had taken that position in Rev. Rul. 69-6, 1969-1 C.B. 104. In that ruling, the Commissioner concluded that the merger of a stock S&L into a mutual S&L does not satisfy the "continuity of interest" requirement and hence constitutes a sale rather than a "reorganization" (1969-1 C.B. at 104-105). In stating the facts upon which the ruling was based, the Commissioner hypothesized a situation in which "Y's obligation to deliver cash deposits to X's shareholders is not severable from its obligation to deliver them a proprietary interest," since "[b]oth the cash equivalents and the proprietary interests are evidenced by passbooks" (1969-1 C.B. at 104). In that passage, however, the Commissioner was not announcing a principle of law, but simply providing an argumentative statement of the facts from the hypothetical taxpayer's point of view. In ruling that the merger was not a reorganization, the Commissioner clearly did separate out the stock and nonstock components of the savings accounts at issue, concluding that "[o]nly minimal value can be assigned to the proprietary interests" and that "the principal property received by [the transferor's shareholders] consists of withdrawable cash deposits as reflected by their passbook balances" (1969-1 C.B. at 104).

3. The record in this case would not permit one to value the equity features of petitioners' savings accounts if one's view were restricted to those features alone. Fortunately, however, that is not necessary, because the record rather clearly shows the value of the accounts' *non-equity* features. Those features consist of the right to withdraw $210,000 in cash, either on demand or at stated intervals, from Citizens. Since the accounts are virtually risk-free and bear an arm's-length interest rate, the fair market value of petitioners' right to withdraw should be equal —and is stipulated (see page 3 note 2, *supra*) to be equal—to the accounts' face value, viz., $210,-000. Since the "fair market value" of petitioners' non-equity rights thus exceeds the gain petitioners realized ($153,000), they must recognize that gain in full (I.R.C. § 356(a)(1)).

This reasoning, of course, produces the same result, as far as petitioners and the other Commerce shareholders are concerned,[32] as our primary submission, *i.e.*, that the merger was not a "reorganization." See pages 13-35, *supra*. This reasoning also suggests that the value of the "equity components" of petitioners'

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[32] This reasoning would not prevent the corporate parties to the merger from enjoying whatever benefits "reorganization" treatment affords. See, *e.g.*, I.R.C. §§ 361, 362.

savings accounts is close to zero. But that merely goes to show that our primary submission is correct.

C. Denial of "reorganization" treatment in this case is supported by sound considerations of tax policy, and there are no countervailing factors in petitioners' favor

1. Common sense fully supports the court of appeals' construction of the Code's reorganization provisions, for any other interpretation would produce anomalous results. If the instant merger were held to be a "reorganization" and petitioners' savings accounts were held to be "stock," petitioners would receive a "substituted basis" in those accounts, *i.e.*, a basis equal to their basis in the Commerce stock they gave up. See I.R.C. § 358(a)(1). Since petitioners' basis in their Commerce stock was $57,000, they would receive a basis of $57,000 in cash equivalents of $210,000. This result would violate the rule, uniform throughout the Internal Revenue Code, that cash, when expressed in United States currency, always has a basis equal to its face value. See, *e.g.*, I.R.C. §§ 301(b), 358(a)(2), 362(c). Were this not so, one would realize gain or loss on making change.

The result petitioners seek would also create serious practical and administrative problems, as even those courts that have ruled against the Commissioner on this question have acknowledged. See, *e.g.*, *Capital Savings & Loan*, 607 F.2d at 977; Pet. App. 15-16 & n.21. Every time petitioners deposited money into their passbook savings accounts, they would have to keep the "new cash" (which would have a basis equal to its face value) separate from the "old cash" (which would have a substituted basis). Every time petitioners withdrew money from their passbook savings accounts, they would be required to recognize gain—a situation whose awkwardness would be even more graphic had petitioners received checking accounts instead of savings certificates (see page 25 note 19, *supra*). If petitioners' CDs matured, and their money were rolled over into another Citizens' account, it would be unclear whether gain should be recognized then, or whether recognition should be deferred until the money was ultimately withdrawn from the association. And if, as petitioners assert, their savings accounts represent "stock," each withdrawal would presumably have to be analyzed under Code Section 302 to determine whether it constituted a "redemption" of stock producing capital gain, or a distribution that was "essentially equivalent to a dividend" and thus taxable as ordinary income (see I.R.C. § 302(b)(1)). To undertake such an analysis, of course, would seem inconsistent with Sections 591 and 593(e), which, as noted above (pages 22-23, *supra*), contemplate that the Code's dividend and redemption rules do not apply to distributions or withdrawals from mutual savings accounts. But that seeming inconsistency only demonstrates the unsoundness of petitioners' basic position.

2. Petitioners contend that the Commissioner's position, upheld by the court below, produces a discriminatory result. As they note (Br. 16), the Commissioner has ruled that a mutual S&L can merge tax-free into a stock S&L (Rev. Rul. 69-646, 1969-2 C.B. 54), and that a mutual S&L can merge tax-free into another mutual S&L (Rev. Rul. 69-3, 1969-1 C.B. 103). Contrariwise, the Commissioner has ruled that a stock S&L cannot merge tax-free into a mutual S&L (Rev. Rul. 69-6, 1969-1 C.B. 104), and that ruling was sustained by the court of appeals here.

Petitioners contend (Br. 40-41) that these rulings collectively place "an unwarranted burden" on mutual institutions seeking to expand their business by acquiring other companies.

The Commissioner's rulings, obviously, do produce different results for different transactions, but the differences are entirely rational. When two mutual associations merge, the depositors simply exchange savings accounts in one for savings accounts in the other; the depositors' proprietary interests (such as they are) continue without alteration, and the depositors cannot meaningfully be said to have "sold" their accounts. See Rev. Rul. 69-3, 1969-1 B.C. at 104. When a mutual association merges into a stock association, the depositors exchange their savings accounts in the former for stock in the latter; the depositors' proprietary interests continue (indeed, are enhanced), and the transaction takes the classic "reorganization" form of an asset acquisition for stock. See *Minnesota Tea*, 296 U.S. at 385. Here, by contrast, petitioners have exchanged their stock in Commerce for savings accounts in Citizens; they have, in essence, liquidated their equity investment, and the transaction has taken the classic "sale" form of an asset acquisition for cash. See *Pinellas Ice*, 287 U.S. at 469-470. In distinguishing this transaction from the other two, the Commissioner's rulings are neither discriminatory nor inconsistent.

3. Finally, petitioners contend (Br. 8-9, 30-38) that there *must* be a way in which a stock S&L can merge into a mutual S&L without adverse tax effects, unless the Internal Revenue Code is to be judged quixotic. Although some other courts seem to have found this idea persuasive (see, *e.g.*, *Capital Savings & Loan*, 607 F.2d at 976), it is completely misguided.

Nothing in the Internal Revenue Code suggests that Congress ever recognized any imperative that stockholders be permitted to dispose of their stock for dollar obligations without recognizing gain, or that corporations be permitted to purchase assets for dollar obligations and take a basis in those assets different from their cost. Indeed, the legislative history demonstrates Congress's understanding that, "[i]n the case of mergers or reorganizations of savings and loan associations," the outcome "depends on whether for tax purposes the merger is characterized as a taxfree reorganization or as a taxable sale." [33] Congress plainly recognized that an amalgamation of S&Ls employing the mechanisms of merger is not necessarily tax-free, and it is hard to imagine a transaction more like a "sale" than this one.

In any event, even if petitioners' idea were not misguided, it has no application here. On the very day of the merger involved in this case—July 1, 1976—a provision of the National Housing Act (enacted

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[33] S. Rep. 91-552, 91st Cong., 1st Sess. 168 (1969) (discussing Tax Reform Act of 1969, Pub. L. No. 91-172, § 432(b), 83 Stat. 622). The provision the Senate Finance Committee was discussing concerned restoration of a bad-debt reserve to the acquired S&L's income, a result that is mandated in the case of a "sale" but not of a "reorganization." The Committee stated (S. Rep. 91-552, *supra*, at 169) that the provision was intended to be declaratory of existing law, and was made explicit in order to avoid the necessity of taxpayers' obtaining advance IRS rulings to that effect. This provision is significant here because it was, with respect to transactions occurring after its effective date (July 11, 1969), a statutory codification of the result reached as to pre-1969 facts in *Home Savings & Loan Ass'n* v. *United States*, 514 F.2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975), the decision which the court of appeals in this case followed and applied. See Pet. App. 25-31.

three years earlier)[34] took effect, which for the first time permitted a federal mutual savings and loan association to convert into a stock form of organization. See *York* v. *Federal Home Loan Bank Board*, 624 F.2d 495 (4th Cir. 1980). Had petitioners and their fellow Commerce shareholders desired to effectuate a reorganization, and exchange their Commerce shares for stock rather than dollars, it would have been possible to convert Citizens into a stock association and proceed with a reorganization on which no gain would have been recognized.[35] In that event, of course, petitioners would not have been able to cash out their equity investment, but that is not something that the Code's reorganization provisions were designed to permit them to do tax-free.

[34] Pub. L. No. 93-100, § 4, 87 Stat. 343, adding 12 U.S.C. 1725(j).

[35] The Bank Board's regulations governing applications for permission to convert from a mutual to a stock form of federally-chartered savings and loan association are set forth at 12 C.F.R. 552.1, 552.2 (1976). These regulations were promulgated on May 14, 1975 (40 Fed. Reg. 20945), in ample time to have permitted Citizens to apply for conversion before the July 1, 1976, effective date of the merger.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

(Statutes as effective in 1976)

INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):

Sec. 116. *Partial exclusion of dividends received by individuals.*

(a) *Exclusion from gross income.*

Gross income does not include amounts received by an individual as dividends from domestic corporations, to the extent that the dividends do not exceed $100. If the dividends received in a taxable year exceed $100, the exclusion provided by the preceding sentence shall apply to the dividends first received in such year.

* * * * *

(c) *Special rules for certain distributions.*
For purposes for subsection (a)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

* * * * *

Sec. 354. *Exchanges of stock and securities in certain reorganizations.*

(a) *General rule.*

(1) *In general*

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) *Limitation*

Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

* * * * *

Sec. 356. *Receipt of additional consideration.*

(a) *Gain on exchanges.*

(1) *Recognition of gain*

If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * *

(d) *Securities as other property.*

For purposes of this section—

(1) *In general*

Except as provided in paragraph (2), the term "other property" includes securities.

(2) *Exceptions*

(A) *Securities with respect to which nonrecognition of gain would be permitted*

The term "other property" does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) *Greater principal amount in section 354 exchange*

If—

(i) in an exchange described in section 354 (other than subsection (c) or (d) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (c) if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

* * * * *

Sec. 368. *Definitions relating to corporate reorganizations.*

(a) *Reorganization.*

(1) *In general*

For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

*   *   *   *   *

Sec. 581. *Definition of bank.*

For purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

Sec. 591. *Deduction for dividends paid on deposits.*

In the case of mutual savings banks, cooperative banks, and domestic building and loan associations and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, there shall be allowed as deductions in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

Sec. 593. *Reserves for losses on loans.*

*   *   *   *   *

(e) *Distribution to shareholders.*

(1) *In general*

For purposes of this chapter, any distribution of property (as defined in section 317(a)) by a domestic building and loan association to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591, shall be treated as made—

(A) first out of its earnings and profits accumulated in taxable years beginning after December 31, 1951, to the extent thereof,

(B) then out of the reserve for losses on qualifying real property loans, to the extent additions to such reserve exceed the additions which would have been allowed under subsection (b) (4),

(C) then out of the supplemental reserve for losses on loans, to the extent thereof,

(D) then out of such other accounts as may be proper.

This paragraph shall apply in the case of any distribution in redemption of stock or in partial or complete liquidation of the association, except that any such distribution shall be treated as made first out of the amount referred to in subparagraph (B), second out of the amount re-

ferred to in subparagraph (C), third out of the amount referred to in subparagraph (A), and then out of such other accounts as may be proper. This paragraph shall not apply to any transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies.

* * * * *

Sec. 1002. *Recognition of gain or loss.*

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

Sec. 7701. *Definitions.*

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * *

(19) *Domestic building and loan association* The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association—

(A) which either (i) is an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C., sec. 1724(a)), or (ii) is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) the business of which consists principally of acquiring the savings of the public and investing in loans; and

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of—

(i) cash,

(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, but not including obligations the interest of which is excludable from gross income under section 103,

(iii) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

(iv) loans secured by a deposit or share of a member,

(v) loans (including redeemable ground rents, as defined in section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property shall include single or multifamily dwellings, facilities in residential developments

dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis,

(vi) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

(vii) loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

(viii) property acquired through the liquidation of defaulted loans described in clause (v), (vi), or (vii),

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary, and

(x) property used by the association in the conduct of the business described in subparagraph (B).

At the election of the taxpayer, the percentage specified in this subparagraph shall be applied on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary. For purposes of clause (v), if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan is deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). For purposes of clause (v), loans made to finance the acquisition or development of land shall be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary, there is reasonable assurance that the property will become residential real property within a period of 3 years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such 3-year period, such land becomes residential real property.

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12 U.S.C. (1976 ed.):

Sec. 1464. *Federal Savings and Loan Associations.*

(a) *Organization authorized.*

In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations," and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home-financing institutions in the United States.

(b) *Capital; members of the association; voting rights; payment of savings accounts and withdrawals; nontransferable order or authorizations; authorization to borrow, give security, act as surety, and issue notes, bonds, debentures, or other obligations.*

(1) An association may raise capital in the form of such savings deposits, shares, or other accounts, for fixed, minimum, or indefinite periods of time (all of which are referred to in this section as savings accounts and all of which shall have the same priority upon liquidation) as are authorized by its charter or by regulations of the Board, and may issue such passbooks, time certificates of deposit, or other evidence of savings accounts as are so authorized. Holders of savings accounts and obligors of an association shall, to such extent as may be provided by its charter or by regulations of the Board, be members of the association, and shall have such voting rights and such other rights as are thereby provided. Except as may be otherwise authorized by the

association's charter or regulation of the Board in the case of savings accounts for fixed or minimum terms of not less than thirty days, the payment of any savings account shall be subject to the right of the association to require such advance notice, not less than thirty days, as shall be provided for by the charter of the association or the regulations of the Board. The payment of withdrawals from savings accounts in the event an association does not pay all withdrawals in full (subject to the right of the association to require notice) shall be subject to such rules and procedures as may be prescribed by the association's charter or by regulation of the Board, but any association which, except as authorized in writing by the Board, fails to make full payment of any withdrawal when due shall be deemed to be in an unsafe or unsound condition to transact business within the meaning of subsection (d) of this section. Savings accounts shall not be subject to check or to withdrawal or transfer on negotiable or transferable order or authorization to the association, but the Board may by regulation provide for withdrawal or transfer of savings accounts upon nontransferable order or authorization.

(2) To such extent as the Board may authorize by regulation or advice in writing, an association may borrow, may give security, may be surety as defined by the Board and may issue such notes, bonds, debentures, or other obligations, or other securities (except capital stock) as the Board may so authorize.

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